Berkshire DIVIDEND STRATEGY

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"Casual Friday" Commentary

Casual Friday: The "Value" Defense + Top 10 Innovation? – *May 15, 2020*

Good morning,

The "Value" defense:
Investor patience and discipline can have a short shelf life. When clients urge: "we need to do something" or "we are not keeping up", it can get in the way of constructing well crafted portfolios. Recently, the investment world generally dominated by high profile U.S. growth stocks has left clients wanting to "chase returns" and we see advisors are seeking concrete evidence to keep clients on track:

- "Can you show why value and dividend stocks make sense now when growth is doing so well?"
- "Can you talk about innovation in these dividend paying companies?"

How big is the performance gap?
Indeed, returns have been elusive for value investors over the past number of years. The gap widened during this downturn - It feels like value investors have "thrown in the towel". Investors want growth - And are willing to pay up! Since the end of 2016 through 5.14.20 the indices have returned:

- Russell Large Growth: +70.21% (Source: Bloomberg)
- Russell Large Value: +2.49% (Source: Bloomberg)

Broader context? Yes, U.S. equity strategies with a value bias have lagged U.S. growth. Keep in mind, results in many other broad equity asset classes - ie. U.S. small/mid, emerging markets, and other large cap international equity strategies (particularly Europe) have fared worse year to date. Sometimes an out-sized move in one asset class (in this case U.S. Large Cap Growth) can taint the merits of every other strategy not keeping up. And within the value asset class, Berkshire Dividend Strategy is well ahead of its index YTD, and maintains 5 star Morningstar rating: 5 Star Morningstar - Overall

Why is growth dominating?

- Value indices contain cyclical sectors. As a recession looms, earnings growth is a scarce commodity, so investors are willing to pay up for exciting growth stories potentially "immune" to a downturn, while avoiding economically sensitive ones.
- There is excitement and allure of "new economy" technology stocks – many are gaining even more limelight as pandemic creates new paradigms favoring today's leaders. Many of these trends ARE legitimate, but we believe there are other, less expensive ways to participate in them.
- Five stocks now make up over 20% of the S&P 500 and the same five stocks make up nearly 35% of the Russell Large Growth index - the highest concentration since 1990. Some of these stocks have been on a tear! https://themarketear.com/posts/c-cfhHbaP6

Strong fundamentals, but too expensive?
The current relative valuations between growth and value are staggering. Growth stocks are trading at the biggest premiums ever to their value counterparts, including 1999:

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Dividend Highlights

- Dividend growth can often provide transparent insight into a company's fundamentals and vitality.
- Dividend growth can provide an attractive stream of increasing cash flow to satisfy many financial objectives.

- **Price Earnings Ratio:** Russell 1000 Growth 28 vs Russell 1000 Value 13.50
- **Price to Book Value:** Russell 1000 Growth 7.45 vs. Russell 1000 Value 1.63
    - Growth vs Value – Relative Price to Book 5.7.20
- **Dividend Yield:** Russell 1000 Growth 1.01% vs. Russell 1000 Value 3.15%

(Source: Bloomberg as of 5/8/2020)

Can Value Stocks Ever Catch Up?
History suggests - Yes. As we get to the other side of this pandemic, we believe earnings growth will broaden out to a wider group of companies. The last time the indices traded near these relative valuations (dot com bubble), the market favored "value" stocks in the years after – in a considerable way:

Total index returns from 06/30/2000 – 5/25/2007
- Russell Large Value +80.70% (Source: Bloomberg)
- Russell Large Growth (-27.91%) (Source: Bloomberg)

Virtually all investment firms (advisors, money managers, mutual funds) tout the need for "Investment Discipline"... An industry buzz word that seems to have lost some meaning. In the Berkshire lexicon, discipline means the ability to allocate capital to investments / asset classes even when they are out of favor, under-performing or unpopular. For today's advisor, it means keeping clients focused on their overall financial plans (not just one benchmark), the merits of diversification (not every thing works all the time) and communicating the right ideas (we will do our best to help!)

Along those lines, an advisor asked us "Can you give me a few bullets points showing innovation and potential for growth in your top holdings?"

Innovation in Berkshire Top Ten Holdings?
Investors, like 99', may be overlooking the innovation and growth aspects of some great companies owned in our dividend strategy – this sets up an opportunity for investors looking to the future:

JPMorgan (JPM)
- Through downturn, banking could become more concentrated
- Leaders in technology solutions, like JPM, may pick up additional market share
- Multiple earnings levers outside of traditional net interest margin
- Extremely well capitalized coming in to crisis, dividend likely to withstand economic pressures

Lockheed Martin (LMT)
- Defense spending remains intact with limited disruption
- Healthy dividend growth with current yield of 2.65%
- Leading innovations in AI, quantum computing and hypersonic technologies

Honeywell (HON)
- Trading 35% off all-time highs – Current dividend yield 2.95%
- Honeywell ThermoRebellion - new temperature monitoring solution that incorporates advanced, infrared imaging technology and artificial intelligence algorithms to conduct non-invasive, preliminary screening of personnel entering a facility (source: PRNewswire)
- Other innovation includes – Virtual engineering, machine learning to fight cyberattacks, robotic cargo unloading and predictive airplane maintenance

Johnson & Johnson (JNJ)
- Has increased dividend for 57 years in a row
- Increased dividend during the current economic downturn
- 1 of 2 companies in the S&P 500 with a AAA balance sheet
- Leading candidate for Coronavirus vaccine

Bristol-Myers (NYSE: BMY)
- BMY's recent acquisition of Celgene creates enormous synergies

- Valuation was one of the cheapest deals in biotech: 8 times 2021 earnings of roughly $6.15/share
  - Deal should create $45 billion in free cash flow over the next 3 years.
- Celgene deal improves both early and late stage pipeline
  - Celgene has 5 products that are expected to launch in the next 18 months
- We think the market is overly concerned with debt from Celgene deal
  - Bristol expects to pay it down aggressively over 4 years

Walmart (WMT)

- Massive e-commerce growth over the past number of years
- Leverage brick and mortar presence to enhance e-commerce experience and distribution
  - Wal-Mart stores within 10 miles of 90% of the U.S. population
- Heavy investments in consumer-friendly experience paying off

Kinder Morgan (KMI)

- Bear market for energy sector in 2016 has led to years of painful yet constructive restructuring
- We believe a new and improved KMI emerged and is positioned well to withstand current downturn
- Kinder Morgan Increases Dividend 5% during current downturn - https://www.nasdaq.com/press-release/kinder-morgan-increases-dividend-five-percent-and-announces-results-for-first-quarter

Norfolk Southern (NSC)

- Predicative locomotive analytics, automated maintenance and network efficiency all ensure faster more reliable transportation
  - https://www.nsrailtech.com/power-predictive-analytics
- Personnel and locomotive productivity up 15% YOY from continued technology adoption
  - https://seekingalpha.com/article/4341186-norfolk-southern-corporations-nsc-ceo-jim-squires-on-q1-2020-results-earnings-call-transcript?part=single

General Mills (GIS)

- "Boring" packaged food companies seeing a boost as grocery demand sharply rises
- Continued benefits from Blue Buffalo acquisition – paying down debt from the deal
- In March, General Mills' U.S. retail sales were about 45% higher than a year ago, according to market researcher Nielsen. In April, they were up 32%. (Source: General Mills Earnings Call)

Microsoft (MSFT)

- Cloud computing juggernaut with no signs of slowing, Azure = entrenched
- $140Billion in cash and securities, aggressive buyback program and dividend growth
- At one point, MSFT was cast off as a dying company

Qualcomm (QCOM)

- Holds a staggering 140,000 patents and patent applications for 5G technologies (source: WSJ)
- Key player in next generation "chips"
- $30 Billion in stock buybacks over the past 2 years

(All Data Sourced from Bloomberg unless otherwise stated.)

Have a great weekend!
Gerry,

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